Collateral Policy - Central Banking's Powerful Secret Ingredient

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COLLATERAL POLICY—CENTRAL BANKING'S POWERI SECRET INGREDIENT

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Modern economies run on the back of a monetary and financial system through which most transactions ultima central-bank money. As the ultimate issuers of money, central banks are imbued with substantial power to influe markets and the real economy. It is important to understand how they use this power and the associated implic public attention and most academic work focuses on interest-rate policy, central banks also set policy in anotl influence that is more closely linked to the money-creation process, namely with respect to the collateral again issue money. It is a little appreciated or discussed fact that central-bank money is issued against collateral—pape as government bonds, bank bonds and non-marketable credit claims. The details regarding the type of collatera banks accept and the terms of exchange between collateral and money are tucked away in policy docume technocratic-sounding label *collateral framework*. These frameworks constitute a largely ignored, almost hidd monetary policy that have far-reaching, but little understood, consequences. In this article, I outline some central banks use their power to influence markets and society as a whole through their collateral policies.

The recent growth in the size and influence of central banks underscores the importance of obtaining a deeper u of what they actually do. Over the period 2004 to 2015, the balance sheet of the US Federal Reserve grew fivefold the Eurosystem—the collective structure of national central banks in the euro area spearheaded by the Euro Bank (ECB)—grew threefold. In the euro area, the ECB has even been in the vanguard in the fight to save the European project itself. Mario Draghi has famously declared that the ECB will do "whatever it takes to preser Collateral policy has been central to this.

Collateral frameworks are typically viewed as serving a risk-management function. Just as banks require protection against losses in default when they lend to households and businesses, central banks require collater lend (issue money) to banks. However, there is more to collateral policy than risk management. For example, t created by a central bank's collateral framework may affect the production of financial assets and the underlyin By way of an aphorism, if central-bank money is only available against igloos, or igloo-backed securities, igloos collateral framework that is biased in favor of housing will stimulate the production of housing and, if taken too the risk and severity of a property bubble.

To make the discussion more concrete, below I focus on the collateral framework, or policy, of the Eurosyste especially interesting case because of the complexities that arise from having a single currency across multip problems. It is, therefore, critical to look more carefully at how the Eurosystem operates and the construction of

My approach to this has been to first study the official, legal documentations that describe the fine d Eurosystem's collateral framework and how it has developed over time. To clarify what these documents really m the legal rules are implemented in practice, I have also collected a large number of empirical and practical facts t can best be described as forensic research. The evidence shows that the Eurosystem's collateral framework im forces and discipline. This is surprising given that market discipline is the third pillar of the Basel regulator banks, but is consistent with the view that collateral frameworks represent policy.

In the euro area, central-bank money has traditionally been injected into the banking system via repos, or loans. The quantity of central-bank money a bank can obtain against a particular collateral is its Eurosystem *co* This value is the collateral's "price", as determined within the collateral framework, minus a haircut, or margi the collateral framework. Algebraically, collateral value equals (1-haircut) times "price". I say "price" because t be a theoretical price determined by the central bank rather than a market price. Only a small portion of all se on a regular basis.

The potential impact of collateral frameworks reaches beyond the idea illustrated by the "igloo aphorism" abov affect the production of collateral and real assets. First, and more generally, asset prices may be affected. A which the central bank issues central-bank money may be favored in the market through higher prices, lower re more trading depth. Second, haircuts may be set such that the impact of eligibility differs across asset classes a securities, possibly by design or even inadvertently. For example, to support some banks, the central ba particularly illiquid collateral by giving these assets relatively low haircuts. While this may help channel liquidity is needed", it may also cause distortions in asset and money markets by affecting asset prices asymmetrically the role of market discipline.

Third, collateral frameworks can reduce banks' incentives to monitor debtors by accepting non-marketable colla political influence on banking and financial systems may be facilitated by extending favorable terms to cc government guarantees. Fifth, haircut rules and guarantee policies can interact to increase market segment collateral frameworks can facilitate indirect bailouts, propping up poorly performing banks that should instead optimally. Seventh, favoring illiquid and risky collateral may also weaken the balance sheet of the central bank a financial system more vulnerable to systemic shocks and crises.

The Eurosystem's collateral framework suffers, to varying degrees, from all of the above predicaments. There 40,000 different securities on the *public* list of eligible collateral, ranging from government bonds to unsecured and asset-backed securities. The vast majority of these do not have market prices, and approximately one-third non-regulated markets. There is also what we can call a *private* list of eligible collateral. This is comprised of se asset classes with a relatively high incidence of theoretical prices. Overall, the ECB's collateral policy is biase risky and illiquid collateral. The impairment of market forces is also evident by the fact that the ECB updates every three to four years. Instead of seeing the ECB using markets to set haircuts, one observes the reverse, important segments of the repo markets adopt the stale haircuts set by the ECB.

The collateral policy pursued by the ECB can be described as accommodative. The set of eligible collateral is ex and often tailored to the "needs" of banks in different countries. Collateral can, for example, be "upgrac government guarantees. Not only does an accommodative collateral policy impair market discipline, it is also ar to market integration across Eurozone member states and has probably contributed to financial fragmentatio area. A less accommodative collateral policy would force banks to engage more with each other and foster a mc resilient market for liquidity.

An absence of market forces and discipline at the core of the monetary system creates a vacuum for other forces such as rating agencies and politics. Before the financial crisis, the Eurosystem's collateral framework accepted from three agencies, Moody's, Fitch and Standard and Poor's (S&P). In 2009, a fourth agency, DBRS, was adde This is significant because the baseline rule is that only the highest rating matters, with the lowest haircuts classes achieved for collateral rated A- or higher. Collateral rated below BBB- is ineligible. I document that DI pivotal in giving Italy and Spain ratings of A- and Portugal a rating of BBB- over long stretches of time (all ratir on the S&P scale). This added around EUR 200-300 billion in increased Eurosystem collateral value to bonds is: countries and can be interpreted, therefore, as having helped facilitate indirect bailouts.

DBRS finally downgraded Italy to BBB+ (on the S&P scale) in January 2017, after substantial quantities of sovere bonds had been purchased through the Eurosystem's quantitative-easing program. This "expanded asset purch reduces the importance of the haircuts in normal operations.

In December 2011 and February 2012, the ECB implemented one of its most significant unconventional mone prior to the advent of quantitative easing. In two operations, it offered banks unlimited three-year funding ag collateral. In aggregate, banks took around one trillion euros. At the same time, to take advantage of this opp Italian government granted an unprecedented number of guarantees to low or non-rated Italian bank bonds to i Eurosystem collateral value. In addition, the ECB added around 10,000 unsecured bank bonds trading on n markets to the public list of eligible collateral, even as the value of eligible collateral vastly exceeded banl demand for central-bank money. The overall impression left by the evidence is that the ECB has used collate implement an indirect bailout of some euro area banks and sovereigns.

Collateral policy has been integral to the ECB's bid to stave off the crisis and, in Mario Draghi's words, "preser Over time, the policies of the ECB have spiralled ever outwards in terms of strength. However, because the

indiscriminate. They can also be said to contribute to market uncertainty, in part because it is not clear how pe
are.

Central-bank collateral frameworks are the foundation of the monetary and financial system. They are an overlo
of monetary policy that can affect asset prices, workings of financial markets, profitability of banks and welfare i
economy. A larger place for market forces and discipline within collateral frameworks should help make the fin
more stable and less prone to political pressure or mistakes by policymakers.

The importance of central-bank money in the economy provides central banks with substantial power. Like othe
of power, central banks should arguably be subject to scrutiny, checks and balances. This requires a deeper und
what they do and, especially, of the opaque structure at the heart of central banking and the money-creation pro
central-bank collateral frameworks.

> *This article is based on the author's recent book* Collateral Frameworks: The Open of Central Banks, *Cambridge University Press, Cambridge, United Kingdom, 2017.*

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